In short, AT&T's SFAS 112 exogenous cost amounts are based upon reasoned actuarial standards as to their calculation, and further, the subsequent regulatory separations and allocations processes are justified.

II. EXOGENOUS TREATMENT WILL NOT RESULT IN A DOUBLE COUNT OF SFAS 112-RELATED COSTS.

The Designation Order (¶ 24) states that "because the price indices used to measure inflation in the price cap formula presumably already reflect the cost of postemployment benefits, the companies should include information on what adjustment, if any, should be made in the exogenous adjustment to avoid double counting." No adjustment to the exogenous amount that AT&T claimed for the SFAS 112 transition amount need be made to avoid a double count, because SFAS 112 costs are not reflected in the Gross Domestic Product Price Index ("GDP-PI").

SFAS 112 costs are not included in GDP-PI for two independent reasons. Most fundamentally, SFAS 112 costs are accounting changes only -- they are not economic costs; and the SFAS 112 transition amount is, in any case, a "sunk" cost that would not be reflected in competitive firms' pricing decisions. Because the GDP-PI reflects only economic changes that are included in pricing decisions, SFAS 112-related costs are not accounted for in that index, and thus exogenous treatment will not result in double recovery.[39]

A. The SFAS 112 Transition Amount Is Not An Economic Cost.

There is no GDP-PI double count because SFAS 112 costs are not economic costs, but rather are solely bookkeeping entries. As such, it is undisputed they have no direct impact on cash flow and, hence, on pricing/cost decisions that might influence the GDP-PI. The Commission expressly recognized this in its recent LEC Price Cap Performance Review Order (¶ 282) as to analogous OPEB accounting changes, indicating that ". . . GAAP changes of the type required by SFAS 106 . . . represent only a change in how books are kept and costs are recorded, not an economic cost change that might be expected to affect price . . . ." This conclusion applies equally to the GAAP changes required by SFAS 112.

SFAS 112 is simply a change in the timing of the recognition of postemployment benefit costs on firms' books

[39] Nonetheless, at the time AT&T made its November 1994 SFAS 112 PCI adjustments, AT&T had performed a double count study, which concluded that a small portion (10.14%) of AT&T's SFAS 112 costs could be recovered through GDP-PI, and AT&T reduced its SFAS 112 transition amount by $42 million to reflect that conclusion in its exogenous adjustment. See November 18, 1994 Letter. An explanation of how AT&T computed the 10.14% double count offset is included in Appendix H. AT&T believes that the study's underlying premise (namely, that SFAS 112 are real costs that have an impact on GDP-PI) was erroneous for the reasons stated in Section II of this pleading.

of account.[40] The accounting requirement has no direct impact on cash flow, because SFAS 112-related reserves set up on company books are not required to be funded. Moreover, as the Commission acknowledged in the OPEB Order (¶ 74), a change from cash to accrual accounting "does not change the actual flow of benefits payments the companies make over time." As such, SFAS 112 does not represent a change in the economic costs of the firm. The Commission has also recognized this:

> "most accounting changes will not have an economic cost associated with them . . . . Financial accounting books are designed primarily to give the financial markets an accurate portrayal of the true economics of the corporation. Changes to the accounting books are merely an attempt to make the portrayal more accurate, not necessarily an attempt to make the company behave differently." LEC Price Cap Performance Review Order, ¶ 306.

Corporate management reacts to changes in actual financial and market conditions (e.g., changes in cash flow from either the revenue or expense side). SFAS 112 does not effect such a change.

The Commission has also recognized that financial markets value a company's stock in terms of the discounted

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40 See Duff & Phelps, Credit Decisions, October 9, 1989, p. 8 (". . . [I]t is important to understand that financial statement recognition of the OPEB liability does not constitute an economic event.") See also Moody's March 1991 Special Comment on SFAS 106, p. 3 ("We must recognize that the new reporting, as it involves accrual accounting, is not expected to change our assessment of the prospective cash flow of companies.")

cash flow of the streams of cash payments to and from the firm and that accounting changes that do not affect cash flow will not affect the return on equity.[41] That financial markets, in fact, "look through" accounting changes that do not affect cash flow is borne out by a number of econometric studies. For example, Kaplan and Roll examined the effect on stock prices of two accounting changes in the 1960s that affected only the financial reports prepared for shareholders and had no effect on taxes, cash or any other real economic asset or liability.[42] The accounting changes that were studied boosted reported earnings in the year the change was made, but neither one had an impact on any real factor affecting the firm. The Kaplan and Roll study finds that "[w]e have difficulty discerning any statistically significant effect that [the accounting changes cited above] had on security prices."[43] The authors did see stock prices rise briefly around the date when the firm announces inflated earnings, but that price rise is seen to be

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[41] LEC Price Cap Performance Review Order, ¶ 295.

[42] The two accounting changes studied were: (1) the shift, in 1964, to the flowthrough method of reporting the investment tax credit, and (2) the switch-back from reporting accelerated depreciation to reporting straight-line depreciation (while continuing to use accelerated depreciation for tax purposes). Robert S. Kaplan and Richard Roll, "Investor Evaluation of Accounting Information: Some Empirical Evidence," The Journal of Business, Vol. 45, No. 3, April 1972, pp. 225-57.

[43] Id. at p. 245.

temporary, and is gone by the next quarterly earnings report.[44]

More recently, Tung examined the impact on security returns of SFAS 87, which requires recognition on balance sheets of unfunded pension liabilities, similar to the recognition required by SFAS 112 for postemployment benefits.[45] Although the central hypothesis of the study was that firms with underfunded pensions would see their stock price adversely affected by SFAS 87, the finding was exactly the opposite: "Statement 87 had no material impact on the stock returns of the firms with underfunded pensions."[46]

Taken together, these studies confirm that accounting changes which do not impact cash flow or any real

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44 Archibald, independently, also looked at the stock price performance of 65 firms that switched back from accelerated to straight-line depreciation for reporting purposes, during the period 1955 to 1966. See T. Ross Archibald, "Stock Market Reactions to the Depreciation Switch-Back," The Accounting Review, Vol. 47, No. 1, January 1972, pp. 22-30. Archibald concluded that "[t]he switch-back announcement and resultant profit improvement had no immediate substantial effect on stock market performance." Id. at p. 30.

45 Samuel S. Tung, "Stock Market Reactions to Mandatory Changes in Accounting for Pensions," Doctoral Dissertation, University of Wisconsin - Madison 1987, 113 pp. Tung's analysis used both econometric models and a comparison of risk-adjusted abnormal returns between firms with underfunded pensions and those with overfunded pensions.

46 Id. at p. ii.

economic factor of the firm have no significance in terms of how those firms are valued. By extension, it follows that such accounting changes have no real impact on firm behavior, and hence, on the types of decisions on costs and prices that would be reflected in the GDP-PI.

B. The SFAS 112 Transition Amount Is A "Sunk" Cost.

Moreover, even if it were an economic or cash flow affecting cost, the SFAS 112 transition amount is a "sunk" cost and, as such, has no bearing on corporate pricing decisions. Because rational firms do not consider "sunk" costs in their pricing decisions, SFAS 112 costs will not have an impact on GDP-PI. By definition, the entire SFAS 112 transition amount is associated with services rendered in the past (whether by former, inactive or current employees), and as such, it represents a sunk cost.

Economic theory is clear that sunk costs do not enter into pricing decisions. Rather, prices are determined by economic forces of supply and demand that drive marginal cost and marginal revenue toward equality.[47] Thus, even if

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[47] William S. Brown, Principles of Economics, West Publishing Co., Minneapolis-St. Paul 1995, pp. 266-69.

Marginal cost is the cost associated with producing an extra unit of output. That cost is unaffected by fixed costs, that is, costs that do not vary with output, including sunk costs, such as the SFAS 112 transition amount.

(footnote continued on following page)

the SFAS 112 transition amount were viewed as a real economic cost (instead of what it actually is, simply an accounting entry), it would not affect pricing decisions of firms. As a sunk cost, the SFAS 112 transition amount will not impact marginal costs, and it is ultimately marginal cost and marginal revenue that determine price. Because the SFAS 112 accrual will not affect price, it obviously has no impact on the GDP-PI. In short, no adjustment of AT&T's exogenous cost for the SFAS 112 transition amount is required to avoid a double count.

(footnote continued from previous page)

That fixed costs do not enter into marginal costs is demonstrated by Watson, as shown below:

Let:
MC = Marginal Cost
n = any volume of output
TFC = Total Fixed Cost
TVC = Total Variable Cost
TC = Total Cost (Total Fixed Cost plus Total Variable Cost)

It follows that:

$$\begin{aligned} MC(n) &= TC(n) - TC(n-1) \\ &= [TVC(n) + TFC] - [TVC(n-1) + TFC] \\ &= TVC(n) - TVC(n-1) \end{aligned}$$

D. S. Watson, Price Theory and Its Uses, Houghton, Mifflin Co., Boston 1963, p. 169.

III. EXOGENOUS TREATMENT SHOULD NOT BE LIMITED ONLY TO THOSE SFAS 112 COSTS THAT A CARRIER HAS "FUNDED" OR TO BENEFITS IN WHICH EMPLOYEE INTERESTS HAVE "VESTED."

The Designation Order (Issues E and F) also inquires whether exogenous treatment should be limited to amounts that a carrier has specifically "funded" or to amounts associated with employee interests that have "vested." The Commission should allow exogenous cost treatment for SFAS 112 costs whether or not they are "prefunded" and irrespective of whether the underlying benefits have "vested" for employees.

Neither GAAP, regulatory accounting rules nor price cap regulation requires that a carrier prefund its SFAS 112 costs or accrue such expenses only for employees that have vested interests in postemployment benefits. To the contrary, SFAS 112 expressly requires employers to accrue their postemployment benefit expenses irrespective of prefunding or vesting.[48] Because many employers have not prefunded their postemployment benefit costs and, for the most part, employees do not have vested rights in postemployment benefits, a failure to accrue for nonfunded, nonvested SFAS 112 costs would seriously and inappropriately understate employers' disclosure obligations under SFAS 112.

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[48] SFAS 112, ¶ 6; see n.4, supra.

In these circumstances, imposing either a "prefunding" or "vesting" requirement for exogenous treatment is foreclosed by the DC Circuit OPEB Order. As explained above, the Court ruled that the SFAS accounting change was not under the carrier's control "and, once mandated by the Commission, the change satisfies the control criterion" of the exogenous treatment test.[49] It expressly held that it was impermissible for the Commission to attach new meaning to the term "control," for example, by denying exogenous treatment because the carrier could control the underlying benefit expense.

To condition exogenous treatment on prefunding or employee vesting status would be tantamount to an attempt by the Commission to limit exogenous treatment based on carriers' ability to control the underlying expense, for example, by not setting funds aside or modifying benefit provisions for nonvested employees. Imposing such criteria would directly conflict with the Court's ruling, because under the price cap rules in effect when AT&T filed for exogenous treatment of SFAS 112, there was no room for the Commission to deny such treatment based on a carrier's

[49] DC Circuit OPEB Order, 28 F.3d at 170.

ability to control the underlying postemployment benefit cost.[50]

CONCLUSION

For these reasons, AT&T's exogenous adjustment for the SFAS 112 transition amount was reasonably computed and qualifies fully for exogenous treatment without any additional "double count offset" or limitation as to Company funding/employee vesting status.

Respectfully submitted,

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January 11, 1996[51]

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[50] As noted above (at n.3), recently, the Commission prospectively eliminated exogenous treatment for the LECs' noneconomic accounting costs. See LEC Price Cap Performance Review, ¶ 293. The Commission has similarly proposed (but not yet adopted) such a prospective rule change for AT&T.

[51] This pleading is being filed January 11, 1996 due to the fact that the Commission has been closed since January 2, 1996, the originally scheduled date for the filing.

LIST OF APPENDICES

A SPECIFIC RESPONSES TO INVESTIGATION ISSUES

B FURTHER RESPONSE TO ISSUE NO. 2
(AT&T BENEFITS USED IN SFAS 112 COMPUTATION)

C SFAS 112 EXOGENOUS COST ADJUSTMENT CALCULATION

D AT&T CORP. ANNUAL REPORTS AND SEC FILINGS

E RESPONSE TO ISSUE NO. 42
(SFAS 112 AT&T ASSUMPTIONS AND METHODOLOGY)

F ASSUMPTIONS FOR DETERMINING SFAS 112 TRANSITION AMOUNT

G FURTHER RESPONSE TO ISSUE NO. 50
(AT&T BENEFIT CHANGES POST-SFAS 112)

H ESTIMATE OF SFAS 112 "DOUBLE COUNT" FOR AT&T ASSUMING POSTEMPLOYMENT BENEFIT COST ACCRUALS ARE OF A NATURE TO BE REFLECTED IN THE GDP-PI

A

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SFAS-112 INVESTIGATION
Specific Responses to Investigation Issues

Issue A: Have AT&T and Bell Atlantic correctly calculated the gross amount of SFAS-112 costs that may be subject to exogenous treatment under price cap regulation?

Yes, AT&T has.

1. Describe each type of postemployment benefit covered by the SFAS-112 accounting rules that the company provides to former and inactive employees, their beneficiaries, and any covered dependents. Such benefits include, but are not limited to, the following: salary continuation; supplemental unemployment benefits; severance benefits; disability-related benefits; job training and counseling; and continuation of benefits, such as health care benefits and life insurance. Include the following for each postemployment benefit. (¶ 17)

   The following types of AT&T-provided postemployment benefits were included in the SFAS 112 transition amount, which forms the basis for AT&T's exogenous price cap adjustment.

   1. Postemployment Separation Benefits
   2. Long Term Disability - Income Replacement
   3. Long Term Disability - Medical

2. A description of the specific benefit provided to employees under each type of benefit package (i.e., the combination of benefits offered to any employee). (¶ 17)

   The following types of benefits were included in AT&T's SFAS 112 transition amount.

   1. Postemployment Separation Benefits:
      - Up to 6 months medical coverage for the employee and the employee's covered eligible dependents that were previously covered under the Company medical plan;
      - Severance pay to the employee based on the employee's length of service and management or nonmanagement classification; and
      - Release bonus to the employee (management only) for waiving, in writing, any and all claims against the Company.

2. Long Term Disability - Income Replacement:

   - Replacement for salary or wages for a disabled employee that starts one year after commencement of disability at 50% of the employee's prior basic pay, reduced by income from certain other sources, including social security, workers' compensation, and any AT&T pension benefit. Long term disability income is generally provided until age 65 unless the employee recovers and returns to work or dies before then.

3. Long Term Disability - Medical:

   - Medical benefits provided to an employee who has been disabled for more than one year. This benefit is provided until the employee shifts to pension-related medical coverage, recovers and returns to work or dies.

These benefits are further described in Appendix B.

3. A statement specifying the types of persons eligible to receive each type of postemployment benefit (i.e., employees, their beneficiaries or dependents). (¶ 17)

   See Response to Issue No. 2.

4. A statement as to how long a benefit would continue after separation from the company. (¶ 17)

   See Response to Issue No. 2.

5. In the case of salary continuation, supplemental unemployment, and severance benefits, an explanation of how the company computes the amount received by the employee. (¶ 17)

   AT&T computes severance pay based primarily on an employee's salary/wages and length of service and whether the employee is management or nonmanagement according to the Severance Pay Schedules shown in Appendix B.

6. For disability-related benefits, a description of all benefits provided by the company's disability plan and any workers' compensation plans. (¶ 17)

   The disability-related benefits included in AT&T's SFAS 112 transition amount are described in Response to Issue No. 2. Although AT&T provides other disability benefits (e.g., workers' compensation and accidental disability benefits for job-related injuries, and short-term disability benefits for non-job-related illness or injury), none of these benefits were part of the SFAS 112 calculation.

7. A statement of whether employees are required to contribute to the cost of the postemployment benefit, including the amount of the company's and the employees' contribution. (¶ 17)

Employees are not required to contribute to the postemployment benefit plans described in Response to Issue No. 2. Of course, as to any medical benefits provided under those plans, the usual deductibles and co-payments (if any) apply. See Appendix B.

8. Explain the derivation of the amount of incremental costs that is the basis of exogenous claims including: (¶ 18)

See Responses to Issue Nos. 9 through 15.

9. The date the company implemented SFAS-112. (¶ 18)

AT&T implemented SFAS 112 as of January 1, 1994 for exogenous price cap treatment. For reporting purposes, AT&T implemented SFAS 112 effective January 1, 1993 on both its financial (SEC) and on its regulated (FCC) books. Simultaneous adoption of SFAS 112 for reporting purposes conforms to the Commission's directives in RAO Letter 22.

10. The cost basis of the pay-as-you-go amounts that supported the rates in effect on the initial date that the carrier became subject to price cap regulation. (¶ 18)

AT&T became subject to price cap regulation on July 1, 1989. AT&T Communications' 1988 pay-as-you-go amount, which was included in rates upon commencement of price cap regulation for AT&T, is $48.5 million.

See Response to Issue No. 12.

11. The effect of the price cap formula on that amount up to the date of conversion to SFAS-112. (¶ 18)

1988 Actual Pay-As-You-Go Expenses				$48.5 million
1989 Growth of GNPPI (4.4)	- X (3.0)	=	1.4%	= 49.2 million
1990 Growth of GNPPI (4.6)	- X (3.0)	=	1.6%	= 50.0 million
1991 Growth of GNPPI (3.6)	- X (3.0)	=	0.6%	= 50.3 million
1992 Growth of GNPPI (3.1)	- X (3.0)	=	0.1%	= 50.4 million
1993 Growth of GNPPI (1.9)	- X (3.0)	=	(1.1%)	= 49.8 million
1994 Growth of GNPPI (2.6)	- X (3.0)	=	(0.4%)	= 49.6 million

AT&T converted to SFAS 112 as of January 1, 1994 for exogenous treatment purposes.

See Response to Issue No. 12.

12. The actual cash expenditures related to SFAS-112 for each year since the implementation of price caps, prior to and following the implementation of SFAS-112 accounting methods. (¶ 18)

<u>AT&T Communications Pay-As-You-Go SFAS 112 Expenditures:</u>

1989	$70.5 million
1990	72.5 million
1991	73.8 million
1992	64.7 million
1993	55.4 million
1994	93.2 million

AT&T implemented the SFAS 112 as of January 1, 1994 for exogenous treatment purposes.

Until 1993, AT&T did not track Postemployment Separation Benefit payments related to SFAS 112. Accordingly, to respond to this investigation, AT&T estimated the SFAS 112 separation expenditure for the years 1988 through 1992 based on the actual number of known separated employees and estimated average per-employee separation figures.

Added to these separation amounts were the Long Term Disability-Income Replacement and Long Term Disability-Medical benefits paid each year from 1988 through 1992. For Long Term Disability-Income Replacement, actual expenditures were available for 1990 going forward; the 1988-89 amounts were assumed to decline from the 1990 amount by 5% annually. For Long Term Disability-Medical, the expenditures were estimated for 1988-94 based on an analysis of Long Term Disability-Medical claims for 1992-93, historical medical trend rates, and year-to-year changes in the employee population on long term disability.

13. The presentation of actual cash expenditures in reports to the SEC and to shareholders each year since the implementation of price caps to present, including specific citations to or excerpted materials from, such reports to indicate the amount of liability each party has projected for postemployment benefits. (¶ 18)

Attached as Appendix D are copies of relevant sections of AT&T's 1992-94 Annual Reports to Shareholders, and SEC Quarterly Reports (Form 10Q) for the periods ending March 31, 1993, June 30, 1993, September 30, 1993, March 31, 1994, June 30, 1994, and September 30, 1994 (presented in reverse chronological order). (These are the relevant SEC reports for periods after July 1, 1989, the date of price cap adoption for AT&T.) These reports show that effective January 1, 1993, AT&T Corp. recorded a one-time pre-tax charge of $1.8 billion on its financial books to reflect the unfunded portion of its SFAS 112 accumulated postemployment benefits transition amount. <u>See</u> Appendix D, p. 12. In addition, in that Report, AT&T explained why it was making the accounting change (<u>id.</u>, pp. 8-9), and that apart from this one-time charge, the accounting change should have a $171 million impact on net income and no impact on cash flow (id., p. 12). Line item entries on the income statement and balance sheet indicate the accounting change impact (id., pp. 10-11), although the balance sheet line item includes other accounting changes.

The $0.3 billion difference between the $1.8 billion pre-tax charge reported to shareholders and the $2.1 billion AT&T Corp. transition amount as of January 1, 1994, which is the starting point for the exogenous treatment calculation, relates to the incremental cost (1/1/93 through 12/31/93) associated with SFAS 112 adoption and also reported to shareholders. See Appendix D, p. 12. Inclusion of the calendar year charge of $0.3 billion as part of the SFAS 112 exogenous transition amount is appropriate, because it represents the fact that AT&T adopted SFAS 112 for exogenous treatment purposes effective January 1, 1994, one year later than it had for financial reporting purposes.

14. A description of the forms of postemployment benefit accrual accounting, if any, that were utilized before the effective date of price cap regulation. (¶ 18)

AT&T did not employ accrual accounting for SFAS 112 expenses prior to July 1, 1989, the effective date of price cap regulation.

15. A description of the type and the level of SFAS-112-type expenses reflected in rates before they were adjusted for any exogenous treatment related to SFAS-112. (¶ 18)

See Responses to Issue Nos. 1, 10 and 11.

Issue B: Pre 1/1/94 Exogenous Costs

16. Should exogenous claims be permitted for SFAS-112 costs incurred prior to January 1, 1994, the Commission's date for mandatory compliance? (¶ 19)

No. In accordance with the DC Circuit OPEB Order, the "control" prong of the exogenous treatment test is met as of the mandatory SFAS 112 adoption date of January 1, 1994. AT&T's PCIs include exogenous adjustments for SFAS 112 as of that date.

Issue C: Have AT&T and Bell Atlantic correctly allocated and separated amounts associated with implementation of SFAS-112 in accordance with the Commission's rules? (¶ 20)

Yes, AT&T has.

17. The amounts associated with implementation of SFAS-112 for the total company (including telephone operations and non-telephone operations). (¶ 20)

See Response to Issue No. 13.

The SFAS 112 transition amounts on an AT&T company-wide basis, effective January 1, 1994 for exogenous treatment purposes, are as follows in $ millions:

Postemployment Separation Benefits	$1,895.2
Long Term Disability - Income Replacement	88.3
Long Term Disability - Medical	126.9
Total	$2,110.4

18. An explanation of how total company amounts were calculated. (¶ 20)

The amounts in Response to Issue No. 17 for Postemployment Separation Benefits were calculated in a similar way to the projected benefit obligation for active employees under SFAS 87 (pensions) and the accumulated post-retirement benefit obligation for active employees under SFAS 106 (OPEBs). This is in accordance with SFAS 112 for benefits that accrue over the working lifetimes of the employees. In general, a portion of each employee's Separation Benefit expected to be paid in future years is allocated to years up to the adoption of SFAS 112. Using actuarial assumptions, the present value of these allocated benefits is determined. This is the Separations Benefit component of the SFAS 112 transition amount. AT&T does not maintain plan assets for Separations Benefits.

The amounts shown in Response to Issue No. 17 for Long Term Disability-Income Replacement and Long Term Disability-Medical are determined differently than the amount for Postemployment Separation Benefits. This determination, which is in accordance with SFAS 112, is different because the underlying benefits do not accrue over the employee's career. Consequently, the amounts shown in Response to Issue No. 17 for these two disability-related benefits are calculated only for employees who were already disabled and eligible for Long Term Disability-Income Replacement and Long Term Disability-Medical benefits. (There is no transition amount for active employees.) The transition amount is the present value at the time of adoption of SFAS 112 of the future Long Term Disability (Income Replacement and Medical) benefits of the disabled employees, reduced by plan assets less prepaid plus accrued amounts. This reduction, associated with AT&T's Long Term Disability-Income Replacement VEBA Trust, amounted to $9 million. There are no plan assets for Long Term Disability-Medical benefits.

The methods and assumptions underlying these calculations are explained in more detail in the Response to Issue No. 42.

19. The amounts allocated to the telephone operating companies, the specific Part 32 accounts to which they are assigned, and the amounts allocated to each of those accounts. (¶ 20)

    See Pleading Section I and Appendix C.

20. The method (e.g., head counts, actuarial studies) of allocating amounts to the telephone operating companies. (¶ 20)

    See Pleading Section I and Appendix C.

21. The amounts allocated between regulated and non-regulated activities of the telephone company pursuant to Part 64 of the Commission's rules, together with a description and justification of the methodology for the allocations. (¶ 20)

    See Pleading Section I and Appendix C.

22. The allocation of costs to price cap baskets, by year. (¶ 20)

    See Pleading Section I and Appendix C.

Issue D: How should Voluntary Employee Benefit Association (VEBA) trusts or other mechanisms for funding expenses subject to SFAS-112 be treated:

23. If implemented before price caps.

    Payments that a carrier made to VEBA trusts or other funding mechanisms prior to price caps should not be given exogenous treatment, because these payments would have been included in the carrier's PCIs as of price cap initiation. AT&T did not have any pre-price cap VEBA trusts or other funding mechanisms for postemployment benefits.

24. If implemented after price caps, but before the change required by SFAS-112.

    AT&T established a Long Term Disability-Income Replacement VEBA Trust in 1990 after price caps. VEBA trusts can serve to reduce the SFAS 112 transition amount because they are considered "plan assets" under SFAS 112. The transition amount is the SFAS 112 obligation reduced by the fair market value of "plan assets." However, the plan assets are reduced by any prepaid amounts (previous contributions to the VEBA not expensed) and increased by any accrued amounts (previous benefit amounts paid from the VEBA and expensed rather than paid in cash by the Company). For AT&T's Long Term Disability-Income Replacement VEBA, contributions to the VEBA were not previously expensed and therefore are treated as prepaid. Previous benefit payments from the VEBA were expensed but not paid in cash and thus are treated as accrued amounts. Previous investment income of the VEBA was used as an offset to the accrued amounts because the investment income had previously been included as income by the Company. The end result is that the SFAS 112 transition amount was reduced by $9 million as a result of VEBA plan assets adjusted per the above. The VEBA contributions and investment income less expensed benefit payments are included in the transition amount and qualify for exogenous treatment.

<u>See</u> Responses to Issue Nos. 18 and 30.

25. If implemented after the change in accounting required by SFAS-112.

As noted above, AT&T adopted SFAS 112 for exogenous treatment purposes as of January 1, 1994. In sizing the transition liability as of that date, AT&T properly included the then unfunded SFAS 112 obligation. The unfunded obligation as of January 1, 1994 includes amounts that were subsequently funded and which AT&T expects to continue to prefund, at least in part. These amounts included in the transition amount all qualify for exogenous treatment.

<u>Issue E</u>: Should exogenous treatment for SFAS-112 amounts be limited to costs that are funded?

No. <u>See</u> Pleading Section III.

26. If the company established Voluntary Employee Benefit Association (VEBA) trusts or other mechanisms for funding SFAS-112-type expenses prior to or after the adoption of SFAS-112, whether or not such trusts have since been terminated, provide. (¶ 21)

<u>See</u> Responses to Issue Nos. 27 through 32.

27. A description of any VEBA trust or other funding mechanisms for postemployment benefits established prior to or after the adoption of SFAS-112. (¶ 21)

AT&T has a VEBA trust for Long Term Disability-Income Replacement only. That Trust was established in 1990, prior to adoption of SFAS 112.

28. A statement of the purpose of the VEBA funds and a description of SFAS-112 postemployment benefits covered by each VEBA fund, trust or other mechanism. (¶ 21)

The purposes of the VEBA fund is:

1. To reduce the ongoing expenses of the Long Term Disability-Income Replacement plan;

2. To provide security for the employees by making the receipt of the benefits independent of what happens to the Company; and

3. To assure investors that provision is being made to meet the future liability entailed by the plan that could otherwise jeopardize their interests.

29. The amounts placed in these funds for each year since they were implemented. (¶ 21)

The annual contributions by AT&T on a company-wide basis to the Long Term Disability-Income Replacement VEBA are as follows in $ millions:

1990	$73.9
1991	11.4
1992	10.5
1993	0.0
1994	1.5

30. A description of the amounts placed in the trust for ongoing postemployment benefits and for the transition amount. (¶ 21)

The Long Term Disability-Income Replacement VEBA fund balance less prepaid amounts plus accrued amounts was used to reduce the AT&T company-wide SFAS 112 transition amount by $9 million. Therefore, the entire amount of plan assets less prepaid plus accrued amounts is associated with the transition amount rather than with ongoing SFAS 112 costs. AT&T has not sought exogenous treatment for SFAS 112 costs ongoing after the January 1, 1994 adoption of SFAS 112 for exogenous treatment purposes, only the transition amount.

AT&T has not established VEBAs for the other two benefits reflected in SFAS 112, i.e., Postemployment Separations Benefits and Long Term Disability-Medical benefits.

31. A description of the assumptions made when the funds were set up, including, but not limited to, the time value of money, expected long-term rate of return on plan assets, projected downsizing and layoffs, compensation levels for supplemental unemployment benefits and salary continuation, and age, health, and workplace safety factors affecting the amount and timing of disability-related benefits and continuation of health care and life insurance benefits. (¶ 21)

AT&T's 1990 contribution to the VEBA for Long Term Disability-Income Replacement (LTD Income) was determined based on the present value of future LTD Income benefits for employees who were disabled at that time and in receipt of LTD Income benefits.

The present values were determined by estimating the LTD Income benefits to be paid in all subsequent years while these disabled employees are in receipt of LTD Income benefits. The future stream of estimated benefits was discounted using a 8.5% discount rate to arrive at the present value. In addition to the discount rate, an assumption was used regarding when the disabled employees either recover from disability or die. This assumption is shown on pages 2 through 4 of Appendix F. That table is the 1987 CGDT Table (Commissioners Group Disability Table) and shows rates of termination (from death and recovery) from disability. The table is a published and recognized standard to be used for this purpose.

The ongoing SFAS 112 annual costs include a 9% return on plan assets assumption, which is applicable solely to the Long Term Disability-Income Replacement plan, because it is the only SFAS 112 benefit for which AT&T maintains plan assets. The 9% return assumption is the same return on plan assets assumption used for SFAS 87 (pensions) and SFAS 106 (OPEBs). These SFAS 112 ongoing costs post-January 1, 1994 are not included in AT&T's SFAS 112 exogenous adjustment.

32. A description of the restrictions, if any, that prevent these VEBA funds from being used to fund benefits other than SFAS-112 postemployment benefits. (¶ 21)

The Long Term Disability-Income Replacement VEBA plan assets must be used exclusively to pay for benefits under that employee benefit plan. Pursuant to Section 4976 of the Internal Revenue Code, if any portion of these assets revert to the benefit of the Company, a 100% excise tax will be imposed. Once all of the liabilities under the plan have been satisfied, any remaining assets may be used to provide other permissible benefits in accordance with the provisions of applicable law.

Issue F: Vesting of SFAS-112 Interests

33. Should exogenous treatment be given only for amounts associated with employee interests that have vested? (¶ 22)

No. See Pleading Section III.

34. Provide documentation showing when the employees' interests vest in each type of postemployment benefit offered by the company. (¶ 22)

Other than represented employees who may have certain rights during the term of a collective bargaining agreement only, there is no vesting of SFAS 112 postemployment benefits for employees. Eligibility requirements for SFAS 112 benefits are described in Appendix B.

35. Explain how it was determined when an employee's interest in postemployment benefits vests. (¶ 22)

    See Response to Issue No. 34.

Issue G: Treatment of Deferred Taxes

36. How should the deferred tax benefit applicable to SFAS-112 postemployment benefits be treated for purposes of exogenous adjustments? (¶ 22)

    There is no deferred tax benefit to AT&T as a result of SFAS 112 implementation. Based on IRS regulations, AT&T is not permitted to reduce its taxable income and, as a result, cannot reduce its tax liability until such time as the SFAS 112 benefits are paid or funded and expensed. The actual cash benefits of reduced taxes will be achieved in future years.

37. Describe on a year-by-year basis any exogenous adjustments made to reflect any deferred tax benefit associated with postemployment benefit accrual amounts. Provide an explanation if there are no such adjustments. (¶ 23)

    As indicated in the Response to Issue No. 36, there is no deferred tax benefit to AT&T as a result of SFAS 112 implementation. However, there is a tax effect. In accordance with Part 65 rate base development principles, the inclusion of SFAS 112 expenses for exogenous treatment should include the full recovery of costs, including all expenses as well as recovery on any related investment base. Related capital would include average net investment represented by property, plant and equipment less any accumulated depreciation reserve, and less any accumulated deferred federal income tax reserve. SFAS 112 has no property, plant and equipment or depreciation reserve related to it. It does, however, cause a decrease in deferred income taxes which results in an increase in average net investment.

    AT&T's November 30, 1994 exogenous adjustment included $1.3 million of tax effects associated with SFAS 112 which increased the AT&T Communications' SFAS 112 accrual from $372.1 million to $373.4 million. The $1.3 million revenue requirement was computed by multiplying AT&T's 1993 rate of return of 13.49% by the SFAS 112-related $6.2 million change in deferred federal income tax reserve and its effect on average net investment. This result was grossed-up to a before tax revenue requirement by dividing by one minus .35 (corporate Federal Income Tax rate).

    To the extent AT&T's rates recovered its SFAS 112 expenses, there is an increased tax expense which is offset by the tax benefit AT&T will receive when the SFAS 112 expenses are actually paid or funded.

Supporting Models and Studies

38. Include all studies upon which the company seeks to rely in its demonstration that these accounting changes should be reflected by an exogenous cost adjustment. This includes studies demonstrating any correlation, or lack thereof, between the accounting changes and the current price cap formulas; inflation adjustments to price cap formulas; productivity; previously allowed exogenous changes, such as changes in state tax rates. (¶ 24)

    See Pleading Section II and Appendix H. The D.C. Circuit OPEB Order, 28 F.3d at 172-73, expressly forecloses the Commission from declining exogenous treatment based on intertemporal double count or the productivity double count theories. See Pleading "Background Statement" Section. As explained in Pleading Section I, pay-as-you-go amounts were netted out from the SFAS 112 transition amount for exogenous treatment purposes.

39. Because the price indices used to measure inflation in the price cap formula already reflect the cost of postemployment benefits, include information on what adjustment, if any, should be made in the exogenous adjustment to avoid double counting. If an adjustment has been made, document how it was computed. (¶ 24)

    See Pleading Section II and Appendix H.

40. Include all studies upon which the company seeks to rely to demonstrate that the costs associated with implementation of SFAS-112 were not already reflected in the rates in effect on the initial date that the carrier became subject to price cap regulation. (¶ 24)

    See Response to Issue No. 38.

41. If relying on macroeconomic models, fully describe and document the model, including the method of estimation, parameter estimates, and summary statistics. Provide the same data for any alternate functional forms that were modeled, and the results of any sensitivity analyses performed to determined the effect of using different assumptions, to enable others to replicate results. (¶ 25)

    See Pleading Section II and Appendix H.

42. Provide a complete copy of all actuarial reports and studies used to determine SFAS-112 amounts for each type of postemployment benefit provided by the company. Provide descriptions and justifications of all actuarial assumptions, including the assumptions unique to postemployment benefits, made in computing the SFAS-112 expense. These assumptions should include, but are not limited to, the time value of money, expected rate of return on plan assets, participation rates, per capita claims cost by age, salary progression (for salary continuation and other severance benefits), probability of payment of each type of postemployment benefit,

and assumptions regarding termination from active service due to layoffs (i.e., involuntary separation); downsizing affected through early retirement and reduced hiring; retirement; disability; and death. (¶ 26)

See Appendix E.

43. Discuss what assumptions, if any, were made about other future events such as capping or elimination of benefits, or the possible advent of national health insurance. (¶ 26)

AT&T did not make any assumptions of this type, i.e., AT&T did not "cap" the average claim per recipient for the 6-month medical benefit component of the Postemployment Separation Benefits or the Long Term Disability-Medical benefit.

See also Response to Issue No. 42.

44. Submit all options provided by actuaries from which information was selected to derive SFAS-112 amounts including, but not limited to: the ranges of data on the age and size of the workforce; the ages at which employees separate; and length of separation prior to finding new employment. (¶ 27)

AT&T did not consider options with respect to ages and size of the work force and length of separation prior to finding new employment. Rather, AT&T used the exact ages of the employees and the current size of the work force. Future new employees were not included. With respect to ages at separation and other demographic assumptions, the assumptions were consistent with those used for SFAS 87 and SFAS 106 which enhances their reliability.

Consistency of the SFAS 112 downsizing assumptions and the assumptions used for SFAS 87 and SFAS 106 is assured for the following reason. The same rates of withdrawal and retirement were used for SFAS 87, SFAS 106 and SFAS 112 purposes. The employees assumed to be downsized are reflected in the rates of withdrawal and retirement. For example, the anticipated downsizing is always less than the number of anticipated withdrawals and retirements.

The SFAS 87 and 106 assumptions for 1993 as to rates of mortality, rates of separation, rates of disability, rates of retirement, and rates of pay increases are the same as those shown in Appendix F for the SFAS 112 transition amount.

AT&T did, however, consider alternative downsizing rates. Downsizing data prior to 1988 was considered too out-of-date and downsizing data for 1993 was incomplete. Accordingly, it was decided that the five year period 1988 to 1992 was the most appropriate and credible data to use.